

Mr Andy Stewardson
Room 3C/06
3rd Floor
100 Parliament Street
London SW1A 2BQ

13 January 2010

Dear Andy

Solvency II – Further Questions Paper

I am writing on behalf of the ILAG Tax Practitioner Group to respond to the questions and issues raised in your paper issued on 25 November.

At the outset, ILAG does not have the resources to undertake the full analyses requested in some of your questions. However there are areas where we would like to contribute further to the debate and development of the tax basis in a Solvency II/IFRS 4 phase II environment. This we do by reference to the headings and paragraph numbers in your paper as appropriate plus one additional area.

1. Introduction

We would be grateful for reassurance concerning statements in your paper referring to the basis for computing taxable profits for life companies. Paragraph 1.2 says “the lead option is considered to be to use the financial statements as a basis for taxable profits”. Paragraph 3.3.1 compares the current basis of computing taxable trading profits for general insurance business (based on generally accepted accounting principles etc.) with life companies (based on regulatory surplus). Taxable profits of life companies are of course currently determined under the I minus E basis. Whilst I recognise that your paper of 9 September set out only to address the measure of trading profits, can you nevertheless confirm that nothing in your paper of 25 November should be taken to imply that this will displace I minus E?

2. Aim

No comments.

3. General

3.1 Responses

Tel: 01428 607191
Mobile: 07984 019811
doug.thow@ilag.org.uk

No comments.

3.2 Scope

No comments.

3.3 Adjustments to Profit

We agree that a change to using the annual accounts as a starting point is appropriate when Solvency II is introduced. However, some specific rules or adjustments are necessary to take account of features which are unique to long-term business:

1. We trust that you will accept that policyholder tax and policyholder bonus declarations (including provisions for realistic future bonuses) are uncontroversial items which should be allowed as a deduction in computing trading profits.
2. We also believe that tax relief should be allowed for movements in the Unallocated Divisible Surplus (IFRS) or Fund for Future Appropriations (UK GAAP). These amounts are deducted in arriving at profit in accordance with the relevant financial reporting standard. Balances held in the UDS/FFA represent amounts the allocation of which is yet to be determined in accordance with the contractual terms of the with-profits policies and with the company's Articles of Association. Consistent with the treatment under IFRS 4 Phase I or UK GAAP these balances do not represent shareholder profit, and it is therefore appropriate that they are not treated as such for tax purposes.
3. It is not yet clear whether the current UDS treatment under IFRS 4 Phase I will be continued under IFRS 4 Phase II, or whether some part of the current UDS balance may instead be treated as equity rather than as a liability. But if the IFRS accounts treat any part of the UDS as shareholder profit, then we believe that that amount should be excluded in determining taxable profit. That element of profit cannot be accessed by shareholders and is uncertain until the bonuses are actually declared and the related shareholder transfer is thereby determined.
4. There will inevitably be changes in valuations of assets and liabilities as a result of a move to IFRS, and in particular a change for insurance contract liabilities under IFRS 4 Phase II the effect of which has yet to be fully understood and quantified. However, we understand that under IFRS 4 Phase II the valuation of some liabilities will incorporate a reduction for the anticipated margins on future revenues from existing business. The recognition of future margins as profit does not apply to other types of financial institution and it would place long-term insurers at a disadvantage if they are taxed on them. This is an issue of huge concern to the industry and we believe that a corresponding deduction should be made in arriving at taxable profit.
5. Where the technical provisions required under Solvency II exceed those required under the relevant accounting principles, we believe that an adjustment should be made for the additional provisions required under the regulatory regime. This would be consistent with the relief currently available to general insurers in respect of equalisation reserves, which are required to be held for regulatory return purposes but are not a liability under IFRS.
6. Other fiscal adjustments

- (1) It will be necessary to review other trading profits provisions which do not currently apply to life companies, and to consider whether that approach continues to be appropriate if life company profits are based upon accounting profits rather than the regulatory return. For example, it may be appropriate to review the current structural assets rules and the treatment of investments in group companies and owner-occupied properties.
- (2) Provisions which are specific to life companies, dealing for example with transfers of business or introduced to prevent arbitrage between accounting and regulatory profit measurement, may no longer be required.

4. Special areas for clarification

4.1 Profit recognition profiles

No comments.

4.2 Volatility

We confirm that the reasons for increased volatility are broadly as expressed in the two bullets under 4.2.1, with the second being the more significant. However, in the context of long-term business volatility can extend to market movement over a long period of time. A notable, if extreme, example of this is guaranteed annuity options where contracts which were initially thought to be profitable gave way to serious losses when interest rates reduced many years later. This aspect should be recognised as a particular problem for long-term business and would most sensibly be accommodated by allowing life companies a deduction for amounts set aside as an equalisation reserve.

Hedging has a limited role in mitigating volatility. It can be expensive, especially for small companies, and requires expert knowledge and constant revision if is to work successfully.

4.3 Distributable profits

No comments.

4.4 Transition Options

We feel that there is likely to be little desire for the maintenance of records and completion of the processes to support option A. Any delay in the introduction of IFRS 4 Phase II, resulting in two or more transition periods, would make Option A even more undesirable.

We are not aware of anything which suggests that the Option E scenario is realistically likely and it seems inconceivable that life companies would be required to report on this basis. Therefore we feel that Option E should not be considered further.

Our understanding of Option C in the transition period is that all life companies would be required to adopt IFRS 4 Phase II for tax purposes, although this might be partial only. This would be regardless of whether the company has actually adopted IFRS 4 Phase II for the transition period, if early adoption is permitted. Anything less than full adoption of IFRS 4 Phase II for tax purposes in the transition period would mean that Option C, as well as Option B, also involves an element of double transition.

Our preference is therefore for Option D which would allow companies to choose the method most appropriate to their circumstances and resources.

Whichever option is chosen, it is essential that there is detailed discussion on the transitional mechanics at each stage. For some companies, there may be significant amounts involved on both the transition from the regulatory regime to an accounts regime, and again on the transition to IFRS 4 Phase II. Whilst the major “regime” changes may need to be addressed on the first transition, the measurement changes arising on the second may also be significant. Ensuring that appropriate transitional arrangements apply at each transition stage, whether through spreading or grandfathering will therefore be fundamental.

Additional area

Gross roll-up business

The focus thus far has been on agreeing a basis of measuring trading profits for the life business as a whole. It will then be necessary to consider whether the current categories of business will continue unaltered, and to establish how that basis is applied to GRB.

It is as important that an appropriate tax regime, including the allocation of investment return, applies at GRB level as well as for the long-term business as whole. (Indeed, it is only at this level that the issue of measuring “trading” profits for tax purposes is relevant for mutuals.)

I hope that these comments are useful to your on-going considerations.

Yours sincerely

Graham Wilson
Chairman Tax Practitioner Group